VANDERBILT Ave.
ASSET MANAGEMENT

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An Overview of Sukuk and its Application In Global Fixed Income Markets

Sukuk, commonly known as Islamic bonds, are a recent entry to the world of finance. (Sukuk were used extensively in the Middle Ages, but not in the form by which they are now known in modern finance) The first issuance occurred in 1990, when a subsidiary of Shell in Malaysia raised $30mm. Sukuk are one segment of the fast growing Islamic financial sector that started to take root in the late 1970s. Assets in Islamic finance stood at approximately $1.8 trillion at the end of 2013. Given the vast potential for this segment of global finance, investors may be rewarded for keeping an eye on the development of the Sukuk market as opportunities materialize. GE Capital issued the first Islamic bond by a western industrial company in 2009, highlighting the growing acceptance of Sukuk as an emerging, but potentially important arena for global corporations. In this paper, we will review the most relevant principles of Shari'ah that govern the issuance of Sukuk, note the particular structures used to address these principles, and provide an overview of the current market and its growing significance for investors.

Principles of Islamic Finance

Although Islamic Finance in general and Sukuk in particular are a somewhat recent phenomenon, the principles underlying them have been in existence for over 1,500 years. The most relevant principles to Sukuk within Shari'ah involve the forbiddance of interest, the necessity of identifiable assets being traded, and the prohibition of uncertainty as pertains to contractual terms (not markets).

Prohibition of "Riba" or Interest:

- Shari'ah considers money to be a measuring tool for value and not an "asset" itself, therefore it requires that one should not be able to receive income from money alone
- The generation of money from money is forbidden

Requirement that finance used only for specific or identifiable assets:

- Trading in indebtedness is prohibited as is the issuance of conventional bonds, which represent interest based funding for non specific general corporate purposes
- All returns and cash flows must be directly linked to assets purchased
- Requirement of "tangibility" of assets excludes derivative products

Prohibition of "Gharar" or Uncertainty:

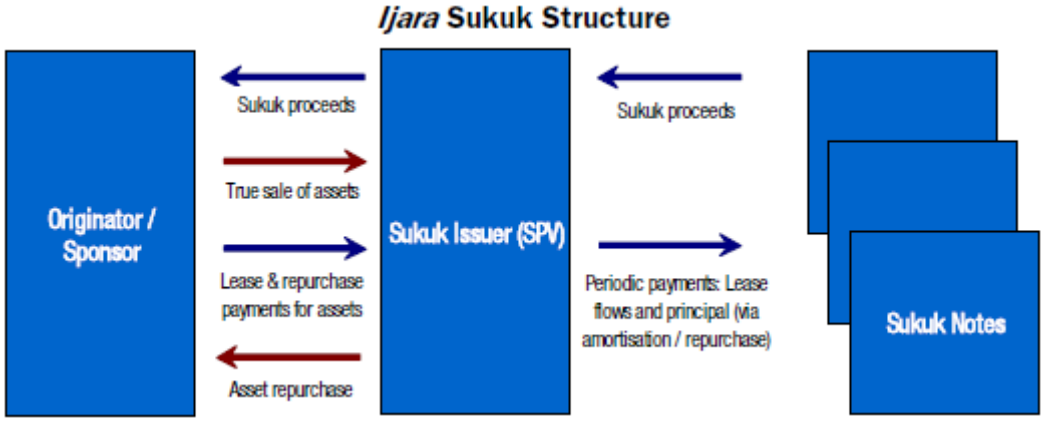
- Uncertainty in contractual terms or uncertainty in the existence of an underlying asset is not allowed.
- Application of the latter creates an issue when considering the use of derivatives, which play a large role in the liquidity of global bond markets. (Derivatives may also be seen as a tool for gambling *(Maysir*), which violates the principle that profits must be earned.)

A number of structures have been created in order to address these principles and make Sukuk suitable for investors. Below we will highlight the two most popular.

Sukuk Structures

Ijara Sukuk (Sale and Leaseback)

- Borrower/Originator sells assets to the Sukuk Special Purpose Vehicle (SPV)
- Investor/Lender purchases shares in the Sukuk SPV and leases assets back to originator.
- The borrower makes regular lease payments to investor, and agrees to buy back assets from investors at a specified time.

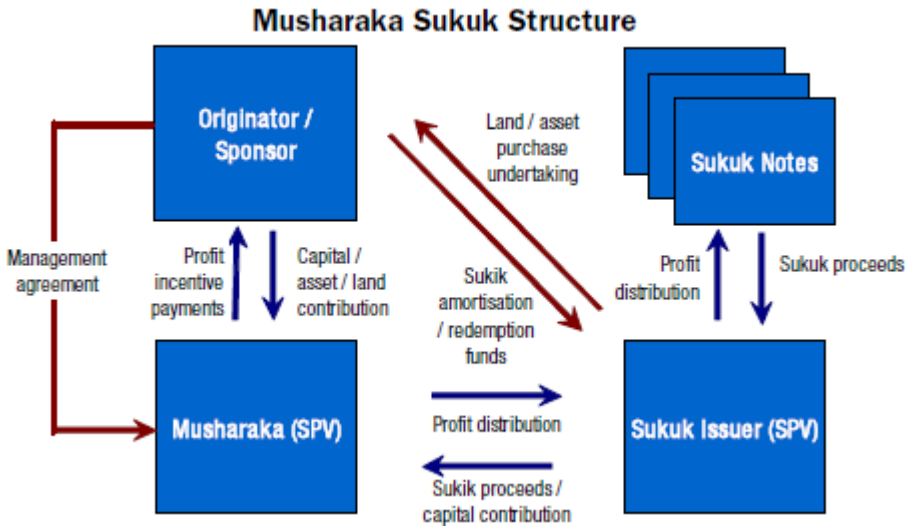


[1]*Source: Shari'ah and Sukuk: A Moody's Primer*

Ijara Sukuk are generally used to represent ownership in well defined existing and known assets tied up to a lease contract. This structure provides identifiable assets, certainty in contractual terms, and substitutes lease payments for interest. Thus it meets Shari'ah compliance. The structure in itself is fairly basic, but Sukuk based on this model can take many different forms. Payments can be bullet or amortizing and fixed or variable. Assets can be anything tangible (land, airplanes, cars, buildings,etc), but depending on whether it is a true sale or a purchase undertaking, the risks taken will reflect either the assets or the originator respectively. The number of variations require careful analysis on an issue by issue basis.

Mushkara Sukuk (Joint Venture)

- Originator/Borrower contributes specific assets and management skills to the Musharaka Sukuk SPV
- Investor/Lender contributes capital to the Sukuk Issuer SPV
- The Sukuk Issuer SPV contributes capital (from the investor/lender) to the Musharaka Sukuk for the originator to invest in accordance with a predefined business plan.
- A profit rate is usually specified based on a share of the income/profit generated.



[1]*Source: Shari'ah and Sukuk: A Moody's Primer*

The Musharaka Sukuk are used mostly to establish a new project or develop an existing one. Similar to the Ijara Sukuk, the Musharaka Sukuk addresses Shari'ah compliance, and can accommodate many variations with just a basic structure in place.

In both Ijara and Musharaka Sukuk, the most common form of repayment of principal is in the form of a "purchase undertaking". This is an agreement by the originator to buy back the assets contributed at a specified time. Thus the critical analysis needs to be done on this agreement and the credit worthiness of the originator/borrower as opposed to the underlying assets.

Current Market

A number of supranational organizations have been making efforts to standardize and regulate Sukuk, such as the Accounting & Auditing Organization for Islamic Financial Institutions (AAOFI) and Islamic Financial Services Board (IFSB). They bring

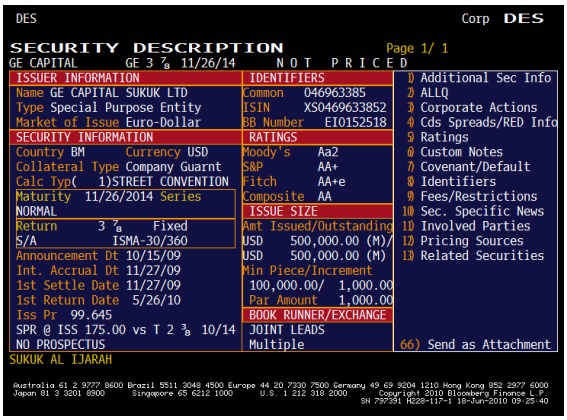
transparency to the accounting standards for these financial instruments and ensure that proper disclosure of financial risks is captured for the investing public. The Islamic Development Bank (IDB), a prominent issuer of Sukuk established in 1975, helps to promote standards and procedures in the Islamic financials sector as well as a sponsoring member of the AAOFI.

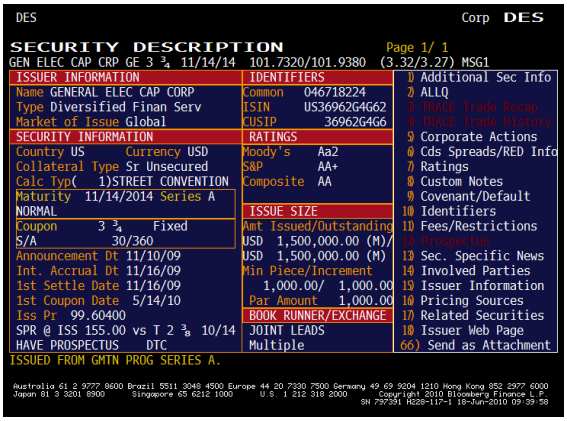
As transparency has improved and progress made toward a consensus on Shari'ah compliant structures, the market in Sukuk continues to take large strides toward global market acceptance.

The growth of this market prompted Citigroup and Dow Jones to launch an index based on the dollar-denominated Sukuk in April 2006. Bahrain plans to launch a bourse dedicated to Shari'ah compliant securities. The Bahrain Financial Exchange is scheduled to open in October 2010 and will start trading Islamic debt next year. The creation of this market will provide liquidity for Sukuk in the secondary market. And as mentioned earlier, this market is not strictly the domain of Asian and Middle Eastern issuers such as the Government of Qatar, Emirates Airline, or Petronas. In addition to the actual issuance by GE and the German Federal State of Saxony-Anhalt, both France and the UK have discussed entering the market at various times.

Practical Applications

Below are the Bloomberg description pages for two GE Capital securities. We chose these examples due to the fact they were issued in close proximity of one another, and that the one on the left is issued as Sukuk, and the one on the right, is a more conventional global bond.





GE Capital issued $500mm International Sukuk in November 2009, which marked a turning point for Islamic securities. It shows a major corporation's willingness to issue specific bond structures to cater to international investor appetite, specifically the Islamic

funds of the Middle East and certain parts of Asia. The deal priced on issuance at 175 basis points over similar maturity treasuries at a price of 99.64, yielding 3.95%.

As a comparison, GE Capital also issued a $1,500mm senior unsecured credit global bond at approximately the same time. This bond has a similar maturity, but a spread of 155 basis points over similar maturity treasuries at a dollar price of 99.61, yielding 3.84%. The premium for the Sukuk bond issued 9 days later than the senior unsecured GE credit was 20 bps. Both bonds were priced using the same 5 year Treasury benchmark. Aris Kekedjian, President and CEO, GE Capital Middle East & Asia Ltd explained the rationale for paying the additional 20bp for entry into this market as thus:

"We continually strive to diversify our funding base. The Sukuk platform helps complement and solidify GE's growing presence in the region and allows us to attract incremental liquidity from Islamic investors. We are proud to announce our secondary listing on the NASDAQ Dubai and look to continue supporting the region in our ongoing efforts."

However, what GE was willing to pay in additional coupon (or, lease payments, as these were based on aircraft leasing obligations) for entry into this market, could represent an opportunity for investors. Both of the above securities involve taking GE risk with a maturity of 5 years, but the Sukuk pays the investor an 1/8 more in coupon. There are two primary reasons investors are being paid more to own the Sukuk. One, although the Sukuk market is growing, it is still small compared to the rest of the global bond market. And two, the relatively untested legal status of its somewhat esoteric nature. The fact that GE Capital paid relatively little to issue in this market suggests that there are investors already comfortable with these risks as they pursue avenues to diversify their portfolios. With growing issuance and a number of institutions governing the market, some of the opacities surrounding these exotic structures will decrease. Examining the risk and rewards of these securitizations could give Western investors an advantage in diversifying their pool of income generating assets and increase their allocation to more stable cash flows.

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